Internal control has its limits

Highlights

- Knowing the limits of internal control can help you anticipate failures and strengthen your system.

- If an organization is not periodically assessing their key risks, they might not truly know if the controls in place are appropriate

- Every executive branch agency must annually certify their system of internal control.

Imagine this scenario: Your agency has completed risk assessments of the most critical processes. Your leadership has evaluated the agency's control environment. They have also completed a plan for next year's risk assessment projects. They then confidently sign the annual internal control system certification form, per statewide policy. It looks like your agency has its internal controls in great shape. Nothing can go wrong now, right? Well, nothing is *likely* to go wrong.

Every system of internal control has its limitations. The best system of internal control in the world can only provide reasonable assurance that bad things will not happen. Knowing the limits of internal control can help you anticipate failures and strengthen your system. It can also help you understand that some risks will simply always be there. Management must thoughtfully consider and accept those risks for the organization to function in the real world.

Here are some ways internal control has its limits.

Poor Judgement. Effective internal controls require good judgement. Employees must make decisions in the time available. They base these decisions on the information at hand. They also must operate under the daily pressure to meet organizational objectives. This introduces opportunities to misjudge what is happening and make bad choices.

Breakdowns. Employees and managers can misunderstand instructions. They can make mistakes. Technology can fail. Key internal controls can be bypassed. For example, a reconciliation can be a key internal control, but it requires savvy people to identify and pursue irregularities to be effective.

Override. Management can override the way the system should function. If people in the organization feel that the rules do not apply to them, the possibility of management override exists. The ethical culture of your organization is a critical component of your system of internal control because it discourages employees from circumventing controls.

Collusion. Segregation of duties reduces the risk of fraud and theft. Yet, two or more employees can conspire together to commit fraud even where duties are separated. Other controls can mitigate this threat. A periodic management review of transactions is a way to reduce the risk of collusion.

Cost/Benefit. The cost of some controls can outweigh the benefits. No one has an unlimited amount of time and money to reduce risk in a process. You need to balance controls against the likelihood and impact a risk poses. Risks and controls are balanced through risk assessment projects. If employees do not periodically assess their key risks, they might not truly know if the controls in place are appropriate.

Suggested action steps: Have you thought about your organization's system of internal control lately? If not, it might be a good time to dust off [MMB Statewide Policy 0102-01](#). Every executive branch agency must annually certify their system of internal control. Think about how the limits of internal control affect your system. Apply these ideas to certification procedures if you are asked to participate.

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